

California's Budget Conflict: *Lessons from the Present and the Past*



Daniel J.B. Mitchell

Ho-Su Wu Professor

*PS 290: Public Budgeting
and Finance*

April 28, 2004

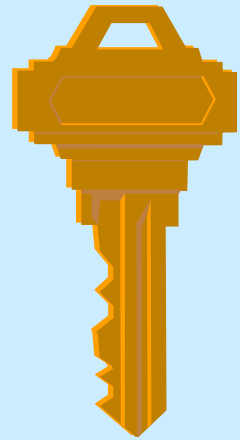
California's Budget Conflict: *Lessons from the Present and the Past*



**Getting to the
fundamental of the state's
current predicament and
looking for long-term
reforms**

Key Sources of State Budget Information

- **Dept. of Finance (budget documents)**
 - www.dof.ca.gov
- **Controller (cash flow statements)**
 - www.sco.ca.gov
- **Treasurer (bond issues)**
 - www.treasurer.ca.gov
- **Governor (press releases)**
 - www.governor.ca.gov
- **Secretary of State (ballot propositions)**
 - www.ss.ca.gov
- **Sacramento Bee (political reporting)**
 - www.sacbee.com



John Vasconcellos

Dem. Senator - San Jose



*“I have never been so frightened
about California’s future as I am
now. The ingredients seem to be
here to take the state right over the
cliff.”*

Keith Richman Rep. Assemblyman - Northridge



“Without bipartisan cooperation, we are headed for a fiscal train wreck.”

“When a State borrows money to construct some great and permanent improvement, and leaves future generations to pay the debt, she also leaves them the work itself, as some sort of compensation. The violation of principle consists in the PRESENT generation assuming to act for and to bind the next without their consent. But the case is still worse, when a State borrows money to defray the ordinary expenses of her civil administration; because she bequeaths a debt to posterity, without any means to pay it.”



Gov. Burnett

Peter Burnett
1st Calif. Governor

“When I previously proposed to the Legislature that we should set something aside for unforeseen needs, some people said I was taking a defeatist attitude—that I should be thinking in terms of prosperity and not depression — but I am still of the opinion that it is no more defeatist for a State to provide for a possible rainy day than it is for an individual to do so. I am as optimistic as anyone about the economic future of our State, but I think it is elementary prudence to establish a rainy day fund.”



Earl Warren
30th Calif. Governor

**“Everybody is entitled
to my opinion.”**

Madonna



...at least starting in 2001

2/12/01: Hirsch and Mitchell,
LA Times, op ed:



“As California’s electricity crisis unfolded, there was much talk about using the state’s “surplus” to fend off high energy costs. ... There is one problem... In the current fiscal year ending June 30, California is running a deficit. And the budget proposals for next fiscal year similarly project a deficit.”



2/23/01: Tim Gage, State Director of Finance, LA Times, Letter to the Editor

“The charge by (Hirsch and Mitchell) that California is running a deficit is flatly untrue.”



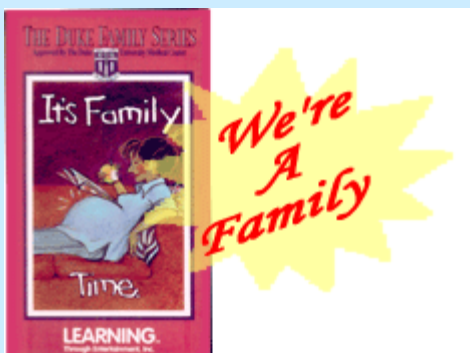
“Who are you gonna believe? Me or your own eyes?”

Groucho Marx



12/18/02: Tim Gage, State Director of Finance, quoted in Gov. Davis' press release announcing Gage's replacement

“I look forward to other opportunities that will allow me to spend more time with my family.”



California's Budget Conflict: *Lessons from the Present and the Past*

- **There is a BIG budget problem**
- **The conflict may not be where you think**
- **California's fiscal history provides some clues about the problem's location**
 - Taxpayer revolt
 - Transportation projects
 - Other public works & services
- **Implications**





Now Available

THE COMIC BOOK OF THE YEAR
ARMAGEDDON





*What's the
real story?*



*Short run vs.
underlying*



The Short Run



Where Have All the
Dollars Gone?

Where Have All The Flowers Gone?

Calypso tempo

P. SEGER



Where have all the flowers gone, long time pas - sing?



Where

go? —



Where

every-one.



When

? —





Where Have All the Dollars Gone?





Where Have All the Dollars Gone?





Where Have All the Dollars Gone?





Where Have All the Dollars Gone?





Where Have All the Dollars Gone?



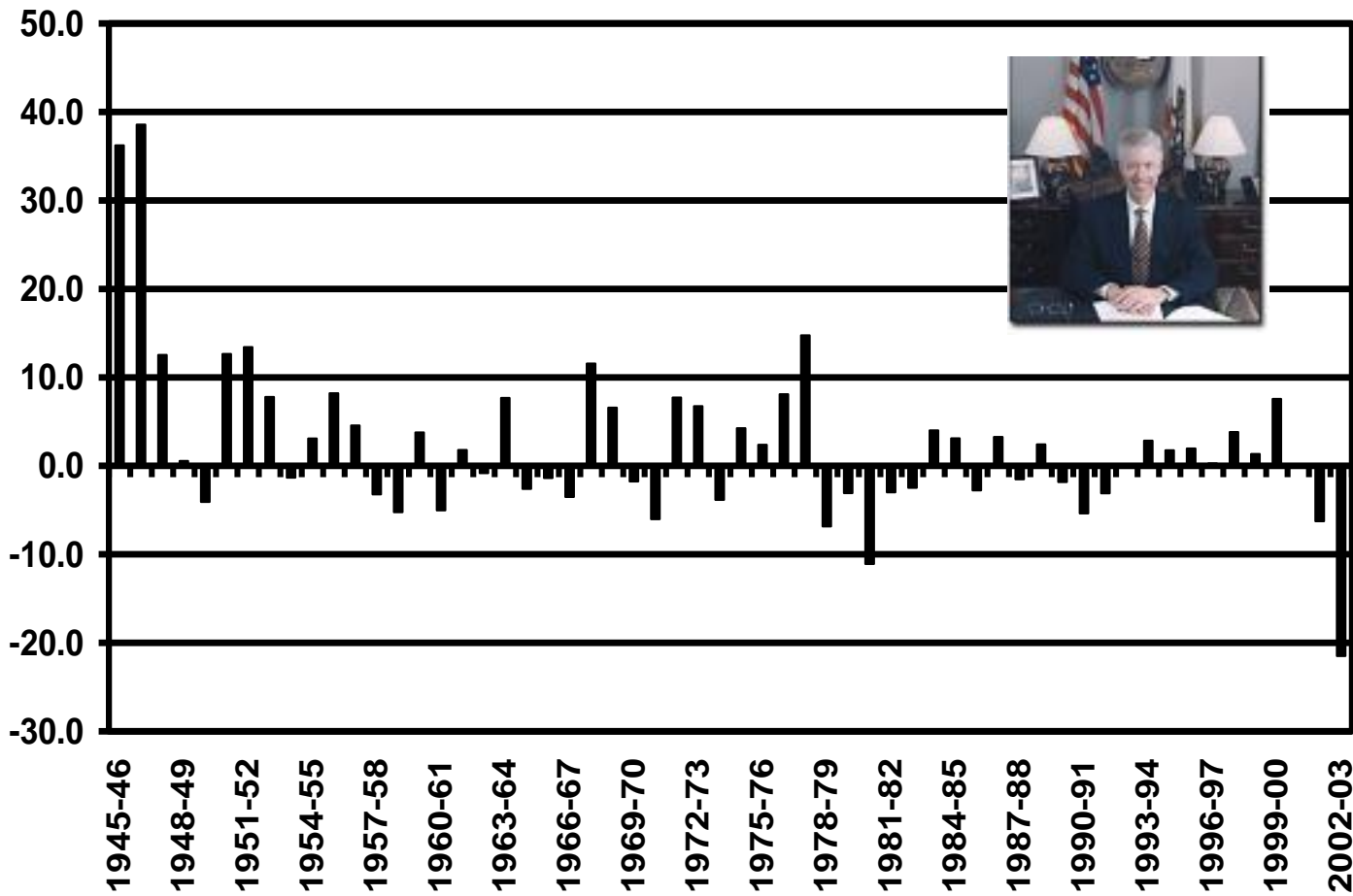


Where Have All the Dollars Gone?



General Fund Surplus or Deficit as Percent of Revenues & Transfers

CPObudget2004.xls
Surplus%

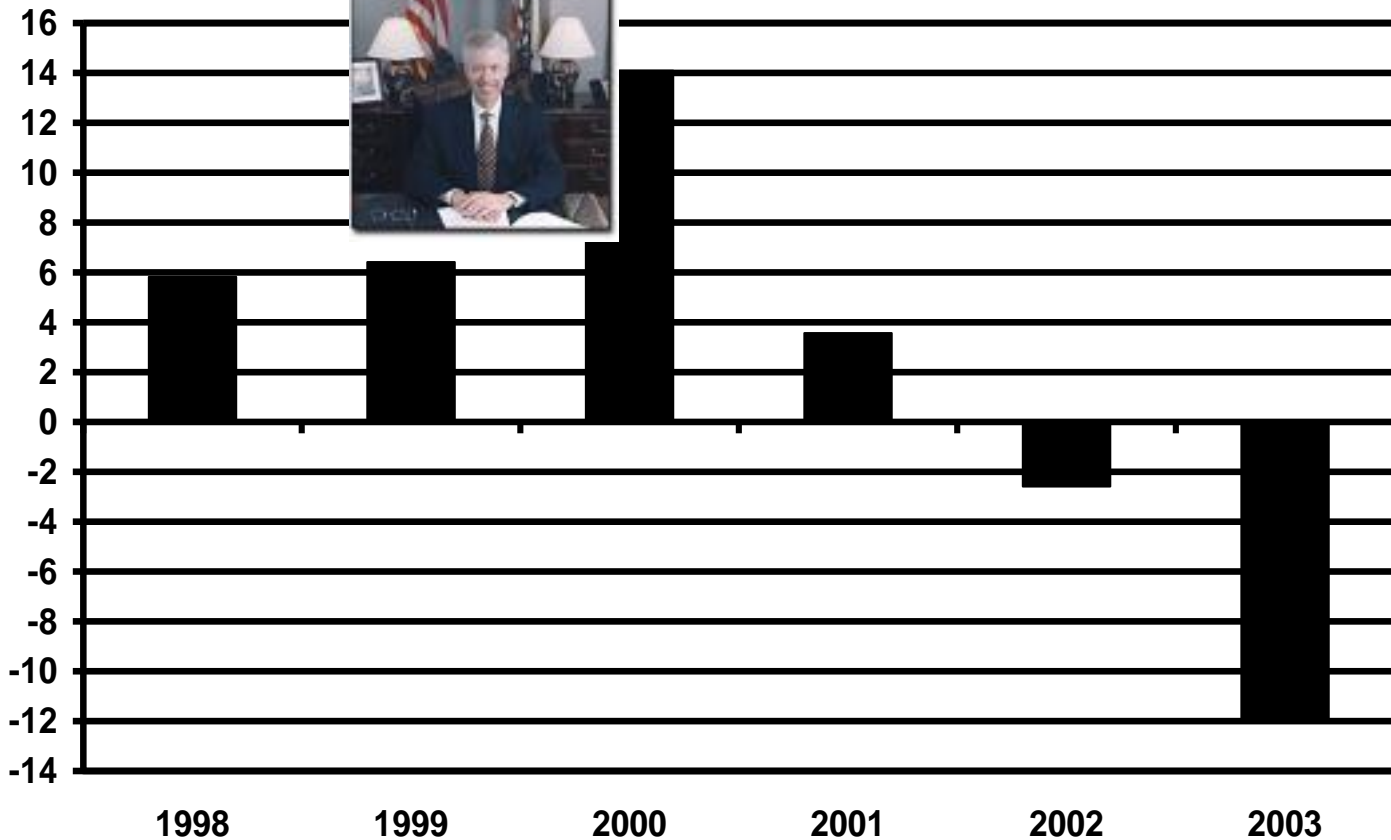


What happened?



**Official Reserve as Percent of Expenditures: June 30 of Year Shown
Excluding Proposed Deficit Finance for 2002-03**

CPObudget2004.xls
offresrv



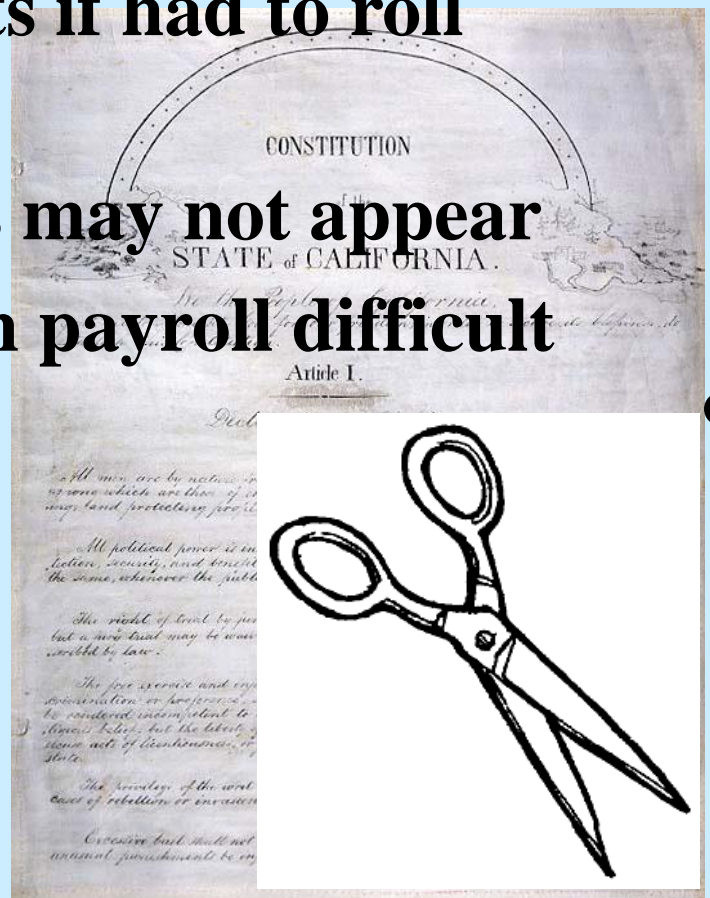
**What
happened?**

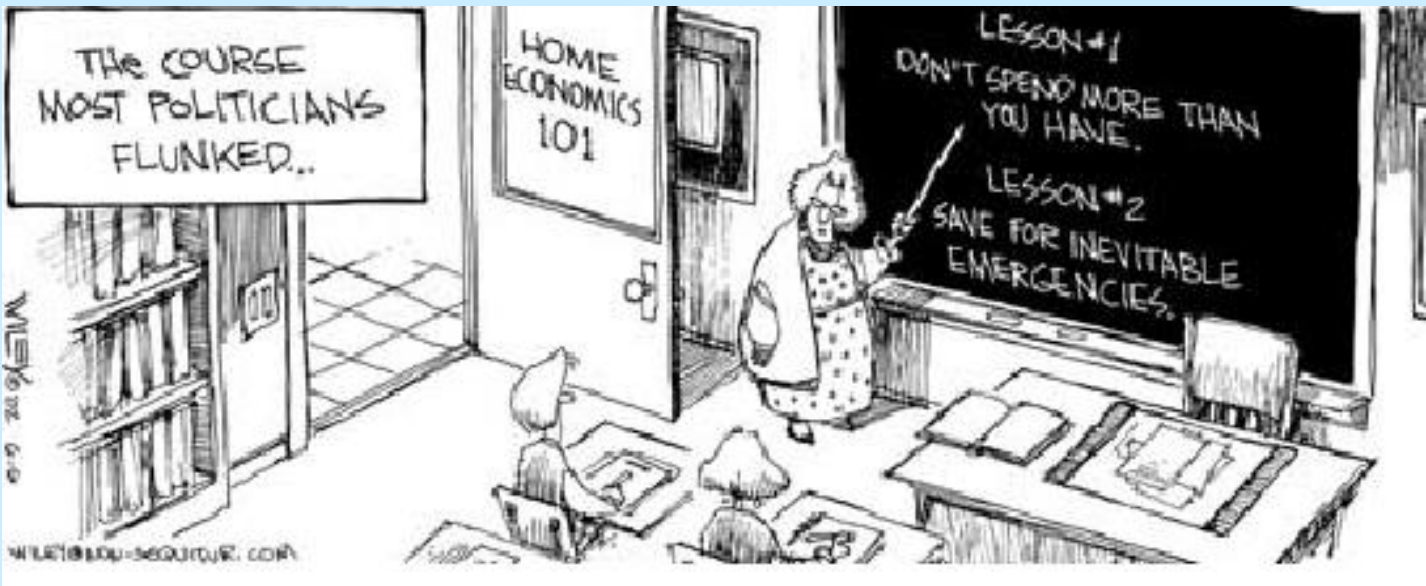


Risks in the “Davis” budget



- Deficit financing proposed was probably illegal (\$2 + \$10.7 billion)
- RAWs & RANs mature in June 2004; high costs if had to roll over
- Some revenues may not appear
- Planned cuts in payroll difficult to achieve





**Why does California
feel exempt?**

If California were a country, it would be the...

- 5th
- 6th
- whatever



largest country in the world
depending on the year chosen.

What does this statement mean?

•

TALES
OF THE OVERLY
OPTIMISTIC..



I THINK I CAN
I THINK I CAN
I THINK I CAN
I THINK I CAN
I THINK I CAN...



VIEW

California has no Alan Greenspan

- **There is no
California
currency**



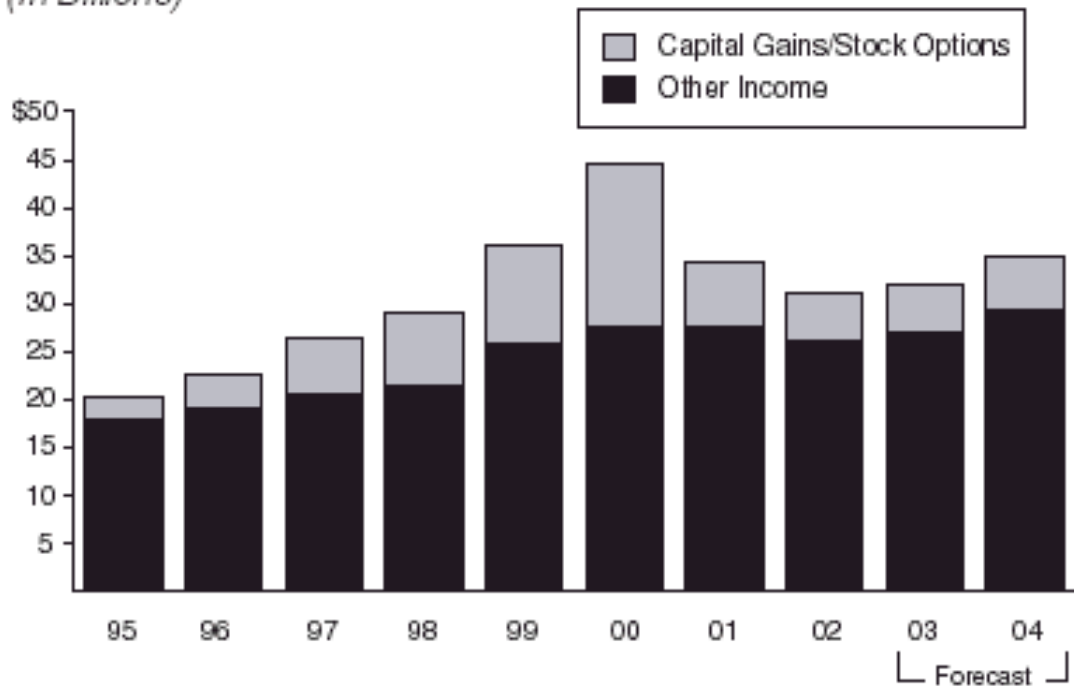
- **Its govt.
can't run big
deficits for
long periods**



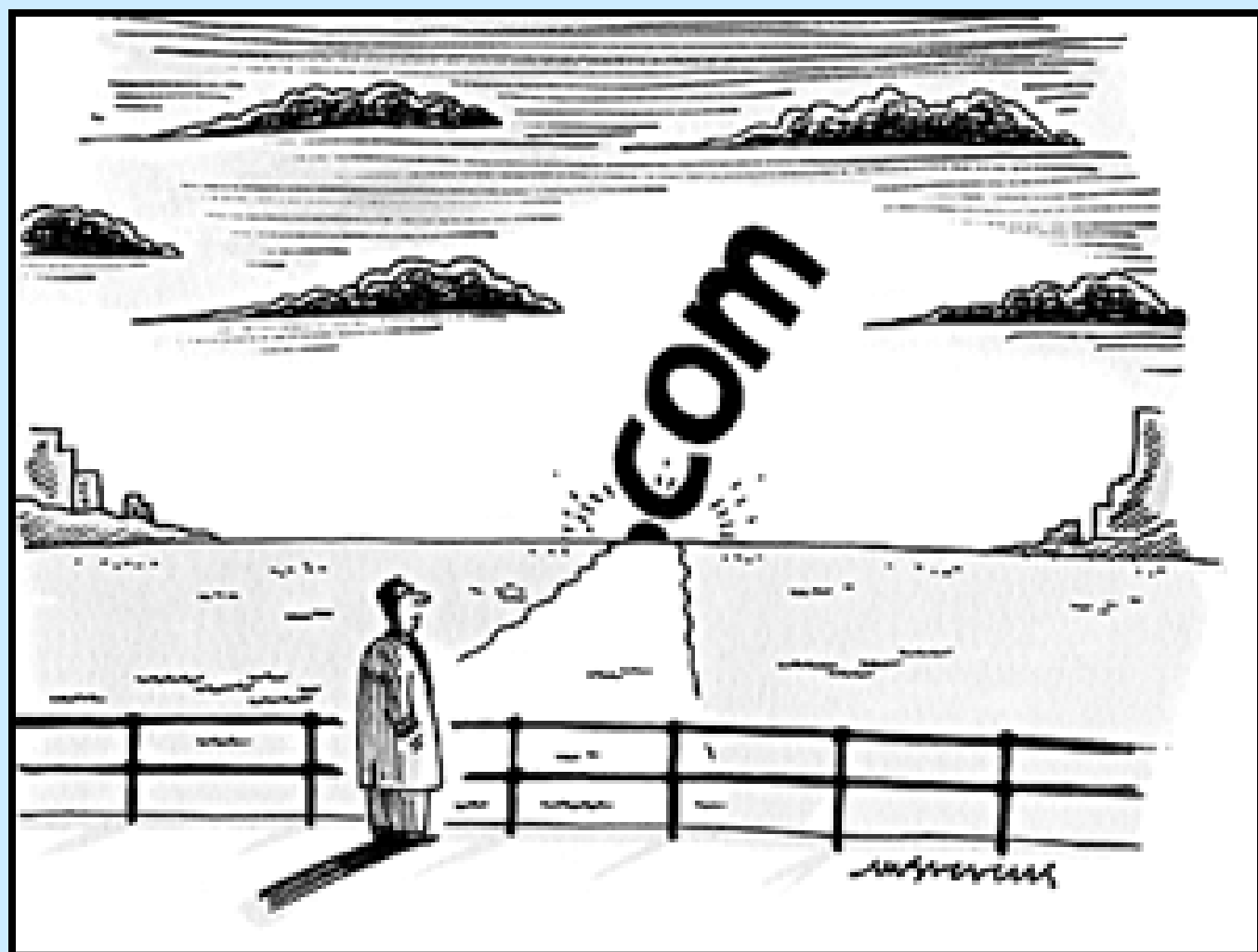
Figure 6

After Plunging, PIT Liabilities to Grow Moderately

*California Annual PIT Liabilities, by Source
(In Billions)*



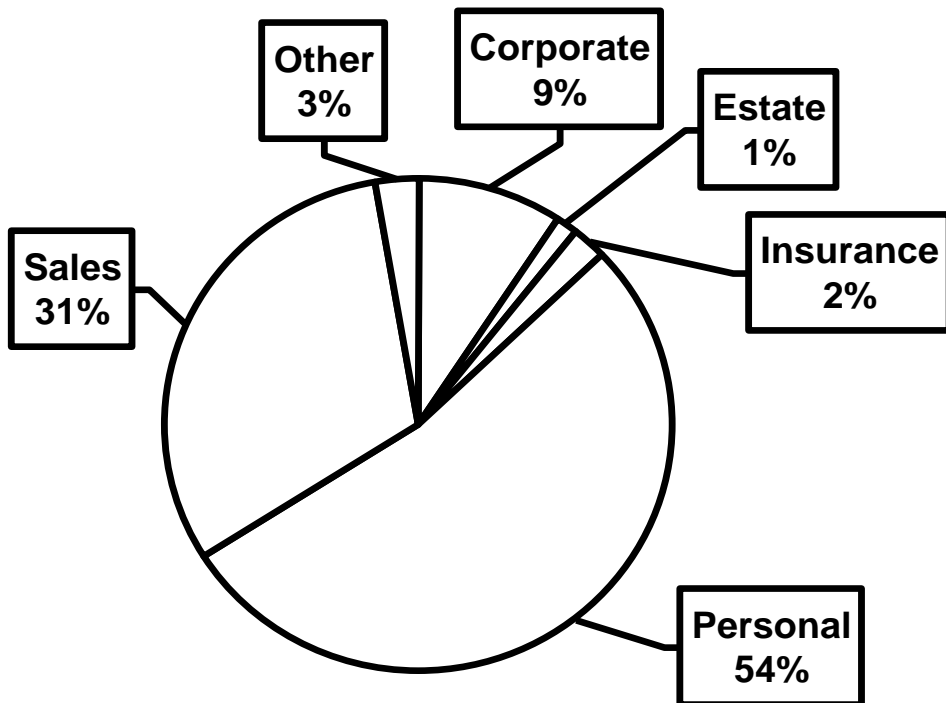
In FY 2000-01, personal income taxes produced \$17 billion in revenue from capital gains (22% of general fund revenue).



Budget Structure

General Fund Revenue Sources: 1997-98 - 2002-03

calborrow.xls
source%

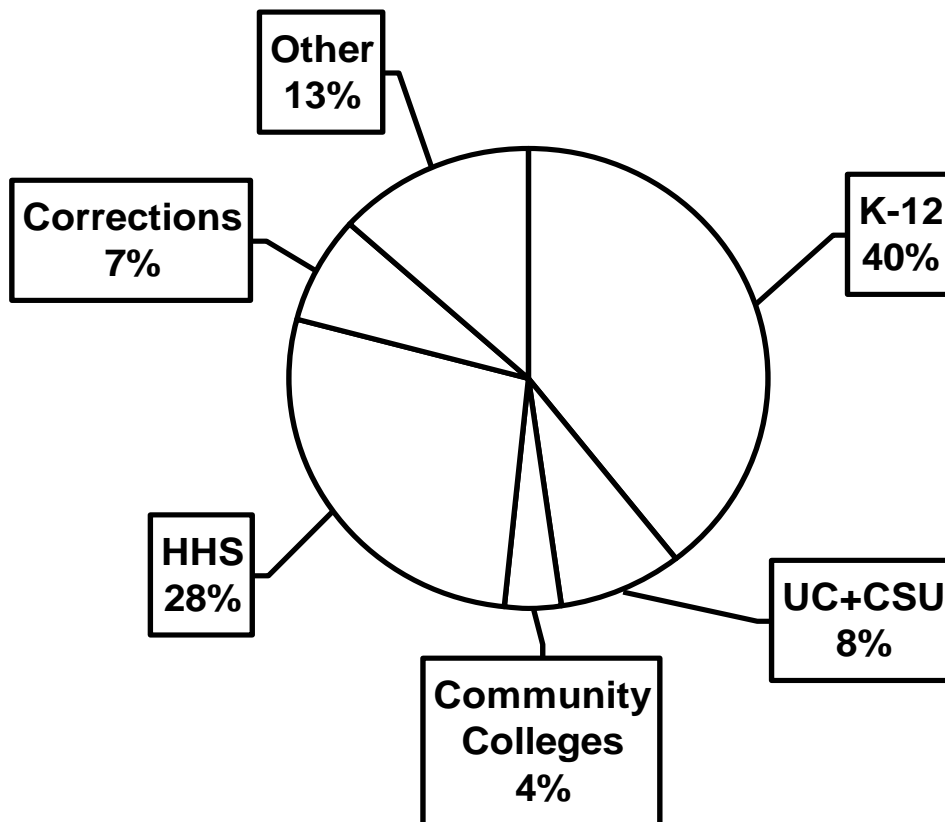


Note: Excludes tobacco bond revenue in 2002-03.

Budget Structure

General Fund Expenditure Categories: 1997-98 - 2002-03

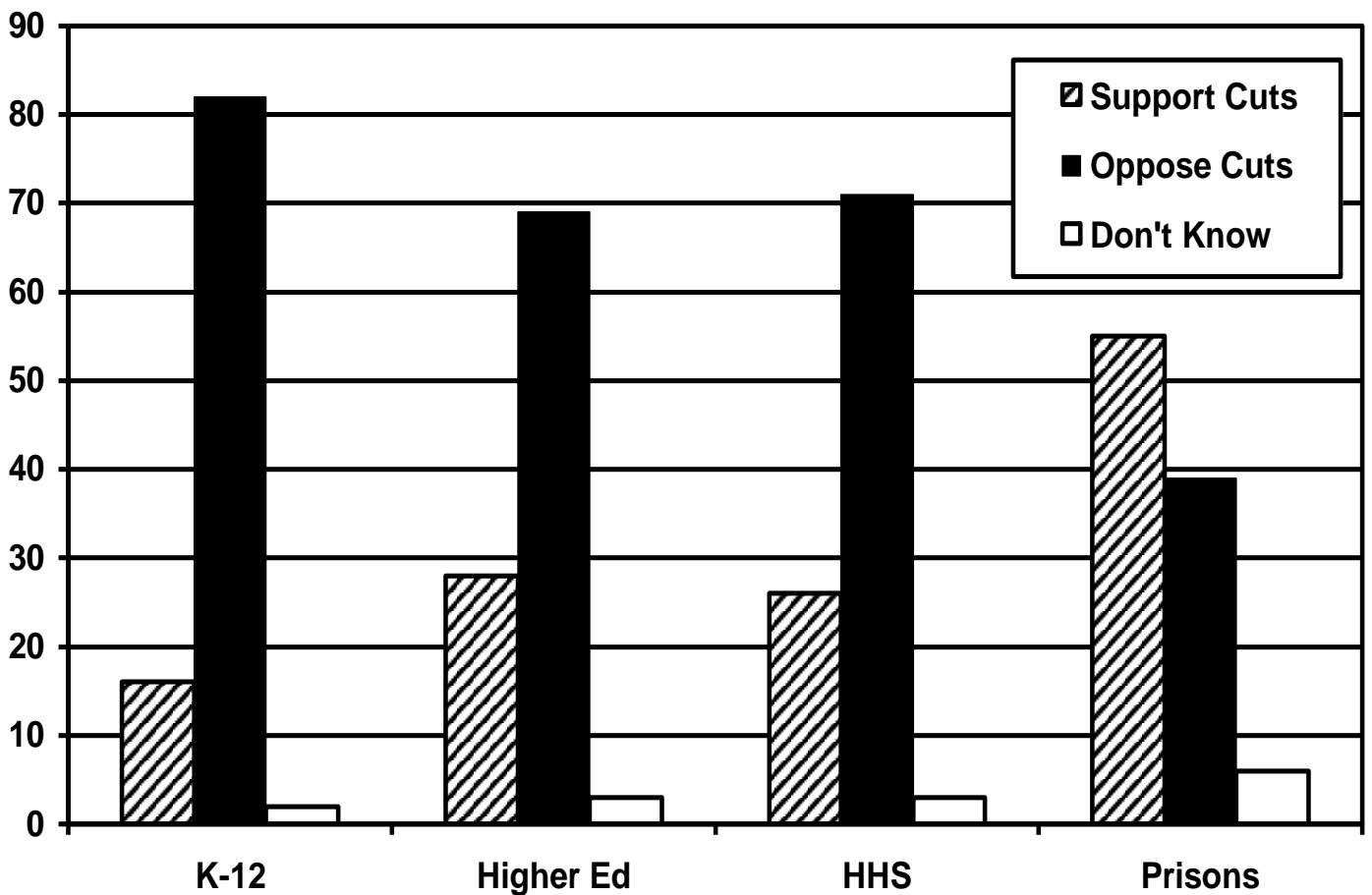
CPObudget2004.xls
spend%



Public Opinion (PPIC)

Opinions of Adult Californians Regarding
Possible Spending Cuts (Percent)

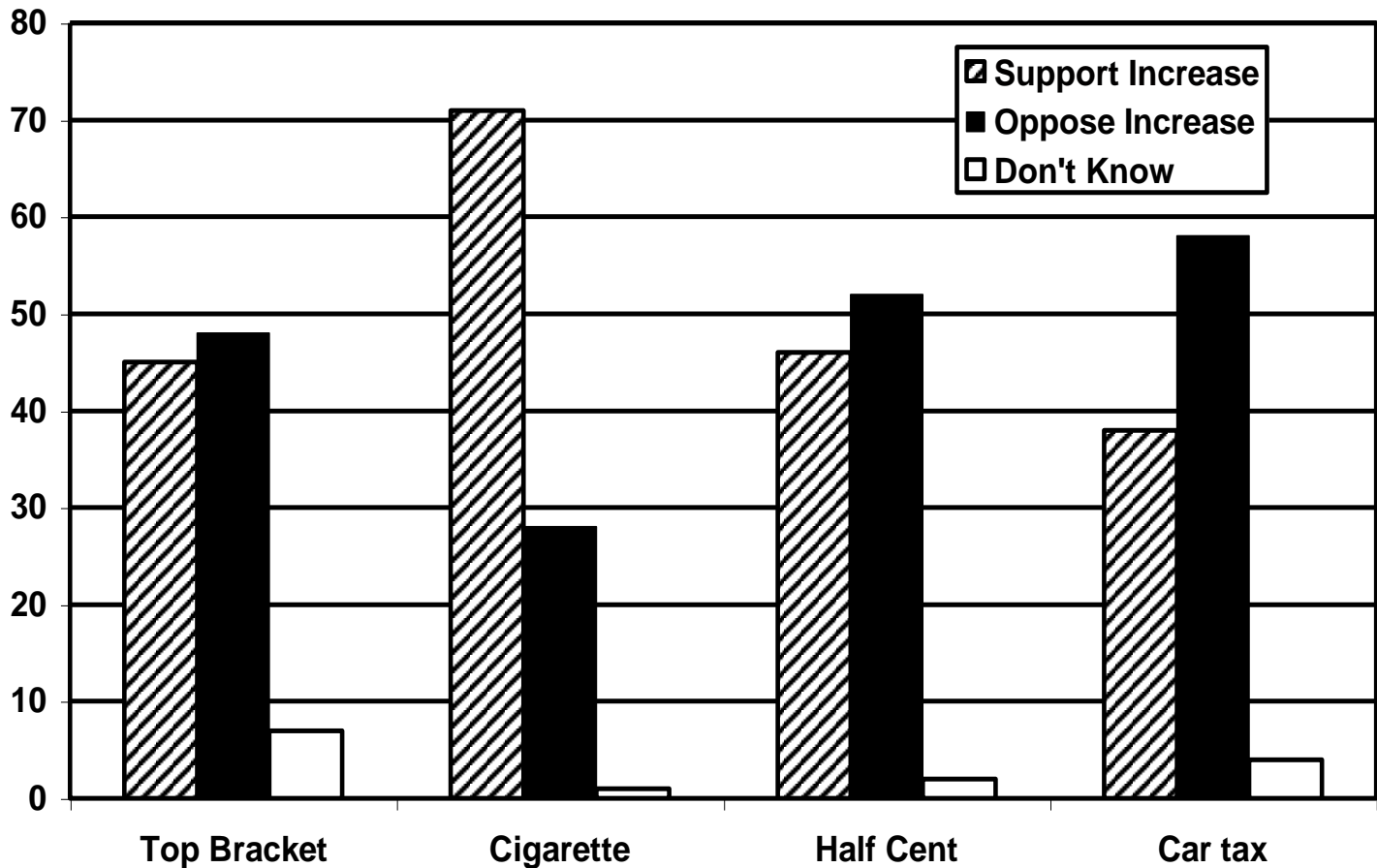
calopinion.xls
spendcut



Public Opinion (PPIC)

Opinions of Adult California Regarding
Potential Tax Increases (Percent)

calopinion.xls
taxup



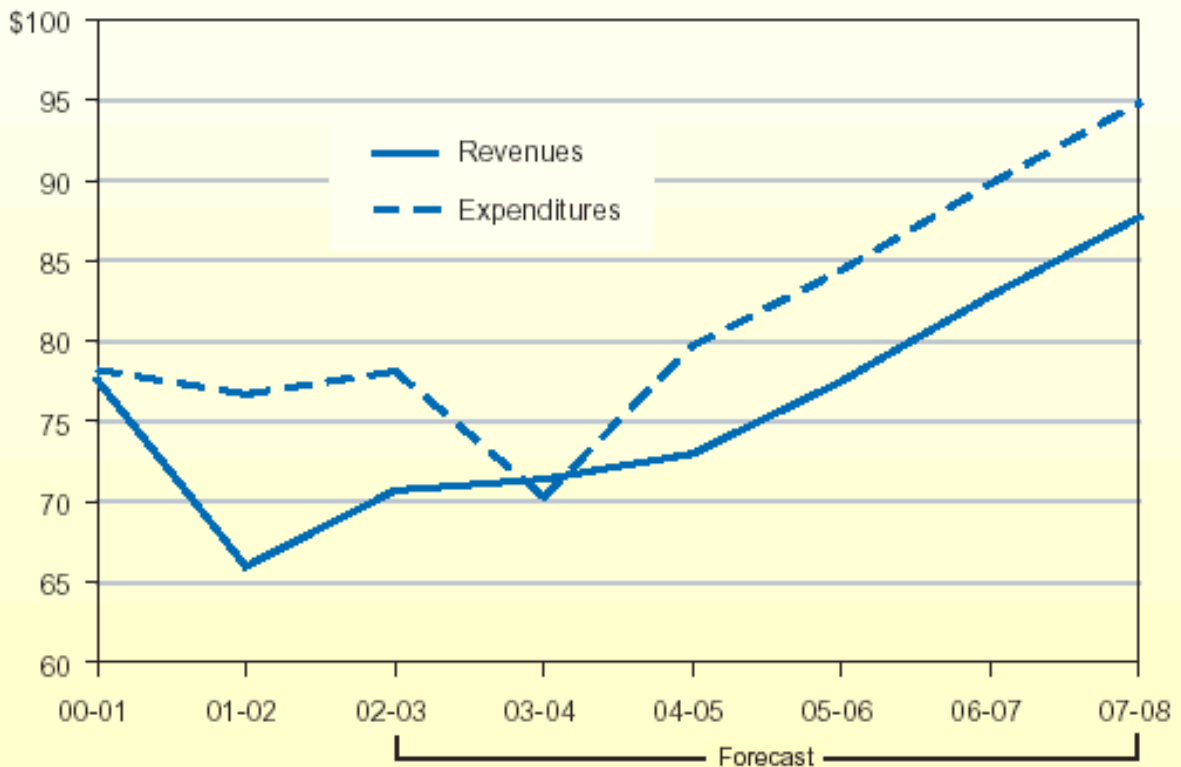
NOTE!

Structural Deficit Estimated by LAO under Davis

Figure 7

Persistent Gap Would Reemerge Under Governor's Plan

*General Fund
(In Billions)*

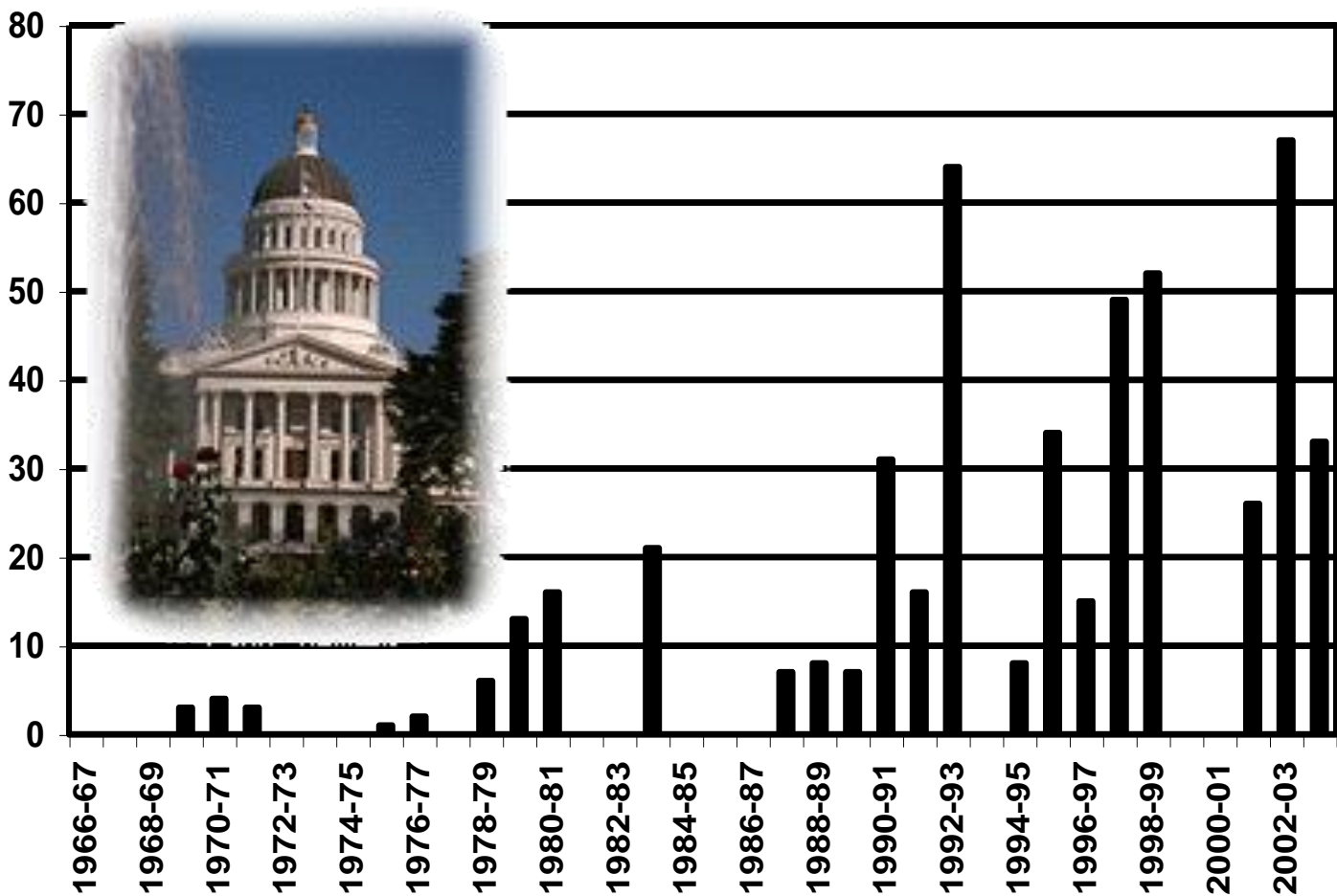


**Rand said same thing
in mid-1990s!**

Legislative Gridlock?

Days of Budget Delay Beyond June 30

CPObudget2004.xls
DELAY2



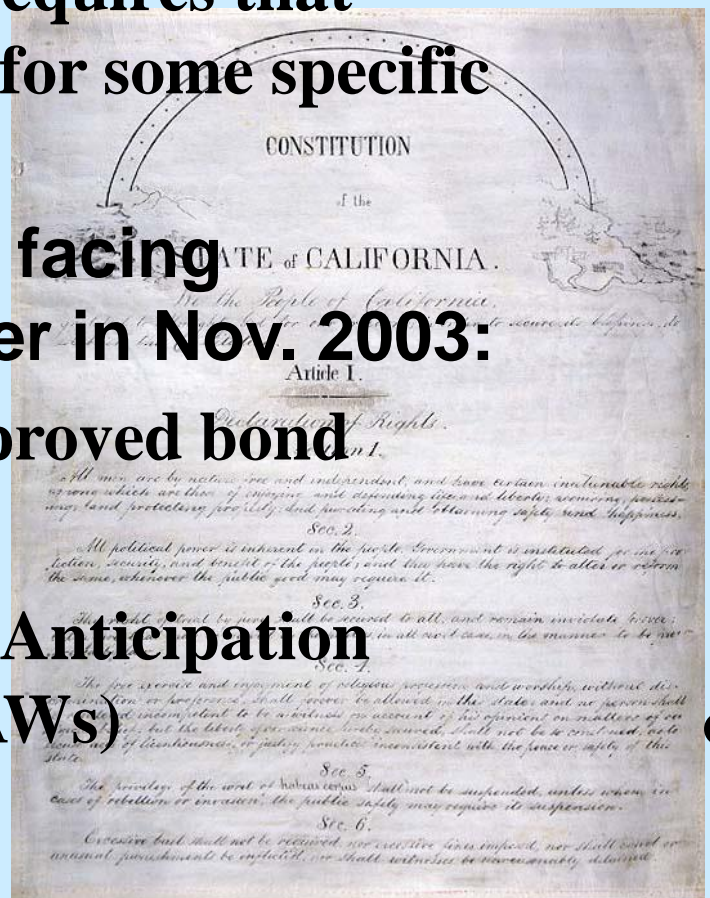
Groping for a Solution

RAVENS
© 2000



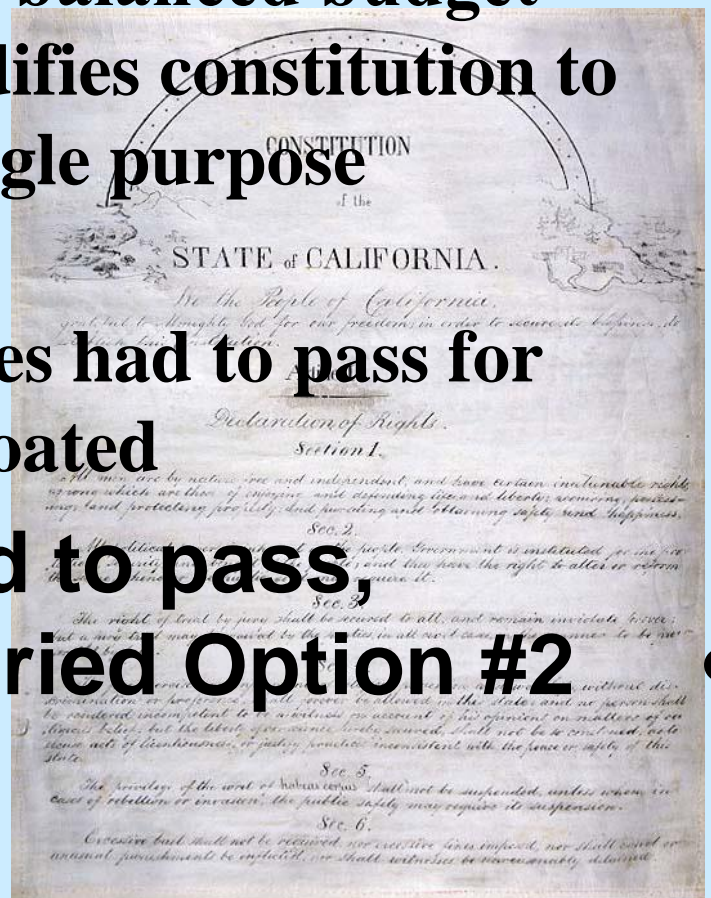
temporary *Groping for a Solution*

- Deficit financing for another year plus refinancing of accumulated debt
 - Constitution requires vote on (long-term) obligations of general fund
 - Constitution requires that borrowing be for some specific purpose
- 3 Options were facing Schwarzenegger in Nov. 2003:
 - New voter approved bond
 - Davis bond
 - New Revenue Anticipation Warrants (RAWs)



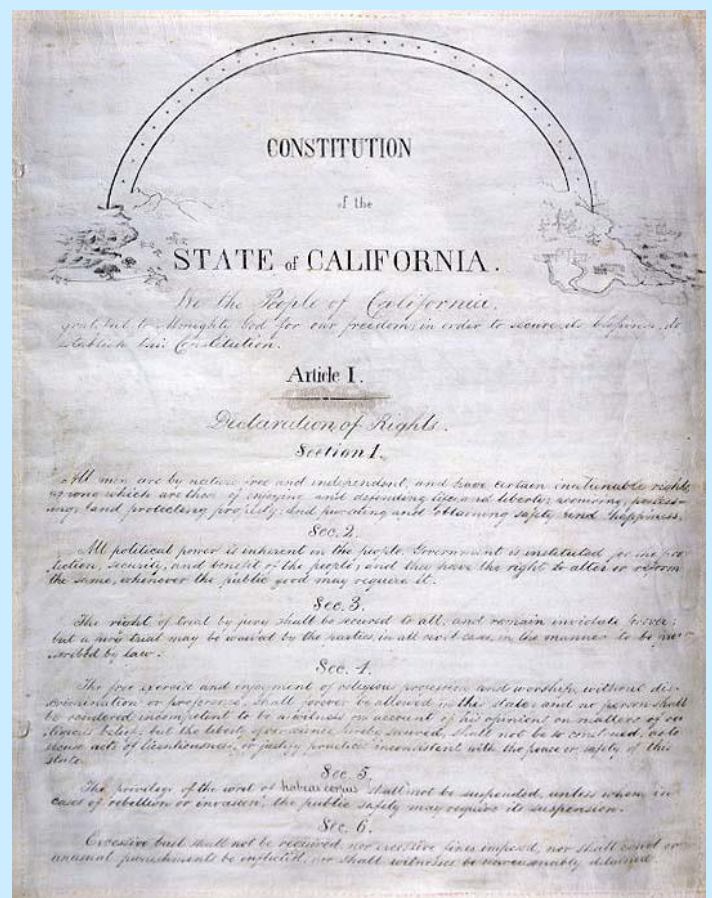
temporary *Groping for a Solution*

- **Option #1: Schwarzenegger \$15 billion bond on March 2004 ballot (Props 57 & 58)**
 - Ballot overcomes constitutional objection on need for vote
 - Companion “balanced budget” measure modifies constitution to overcome single purpose objection
 - Both measures had to pass for bond to be floated
- **If bond failed to pass, might have tried Option #2**



temporary *Groping for a Solution*

- **Option #2: Davis \$10.7 billion bond**
 - Annual vote of Legislature required to pay debt service (to avoid having the bond be considered “long term”)
 - Complicated “triple flip” adopted by Legislature to make bond not an obligation of the general fund



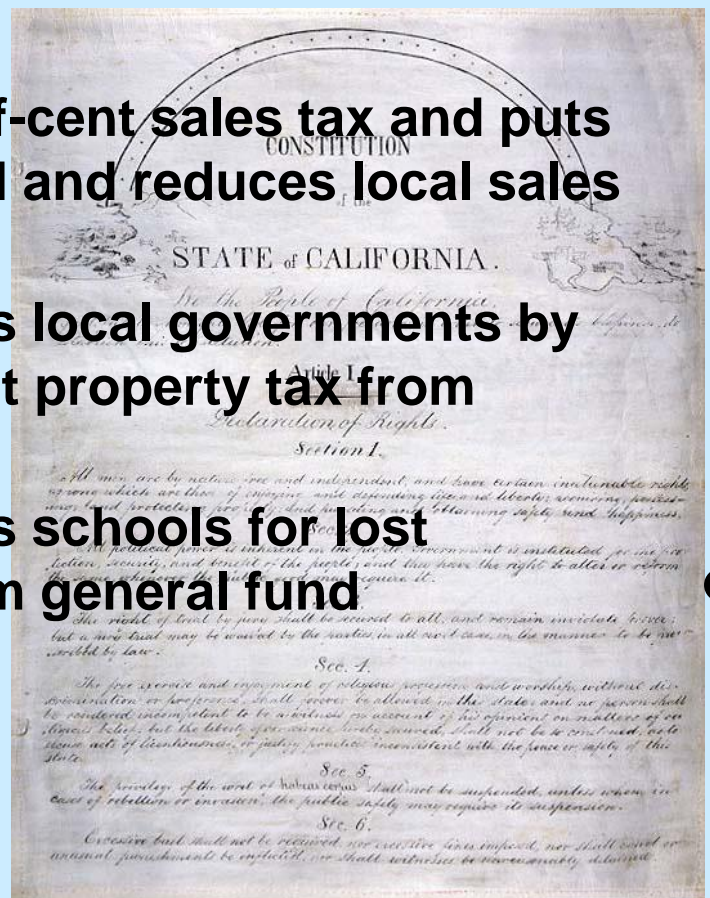
temporary *Groping for a Solution*



- **Options**
 - **Are**
 - to**
 - the**
 - **Can**
 - Le**
 - ob**



- **Triple flip:**
 - **State enacts half-cent sales tax and puts into special fund and reduces local sales tax by half cent**
 - **State reimburses local governments by taking equivalent property tax from schools**
 - **State reimburses schools for lost property tax from general fund**



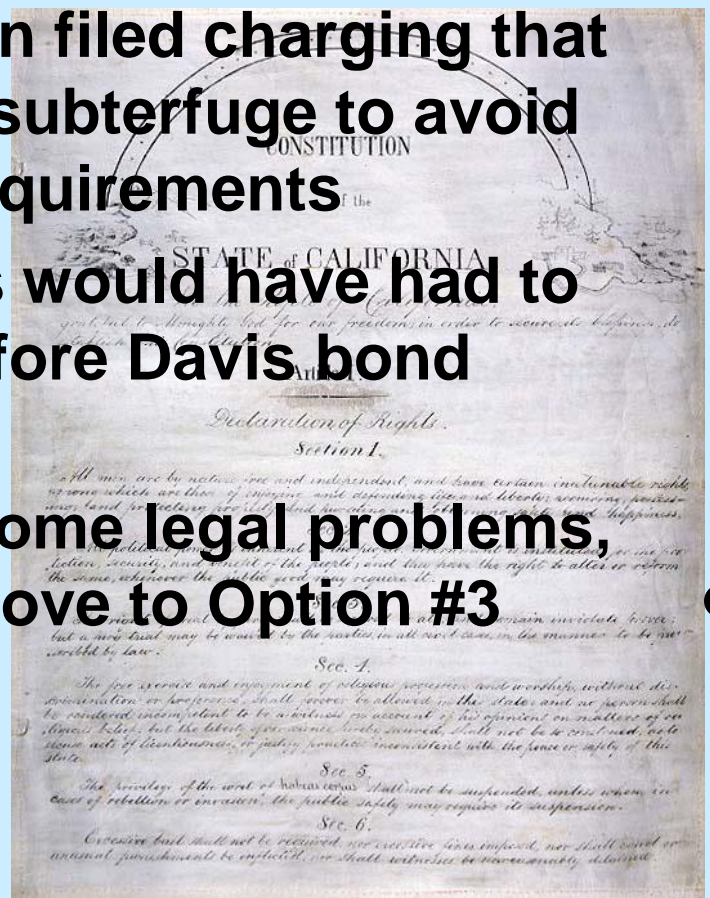
temporary *Groping for a Solution*



- **Options**
 - **Arrest** to the **the** **m**)
 - **Cost** **Le** **ob**



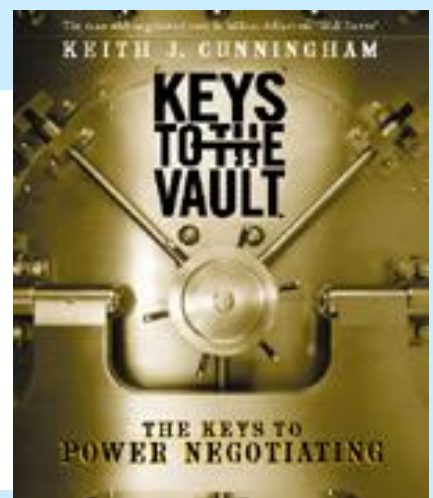
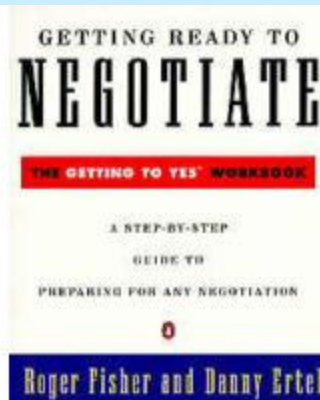
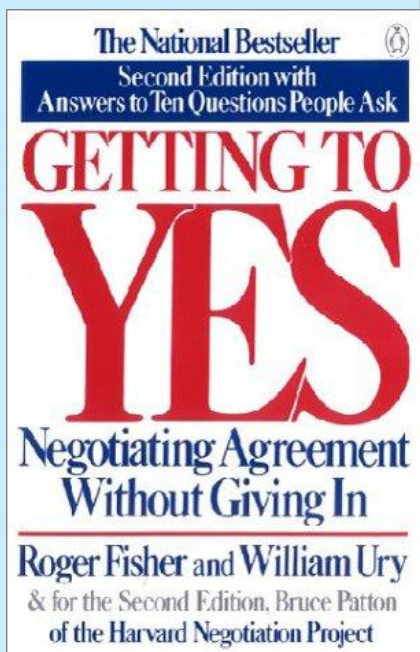
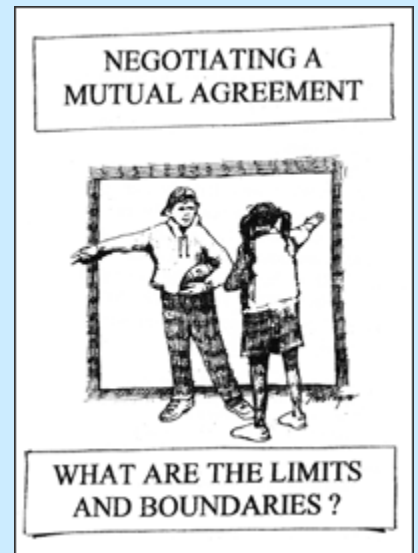
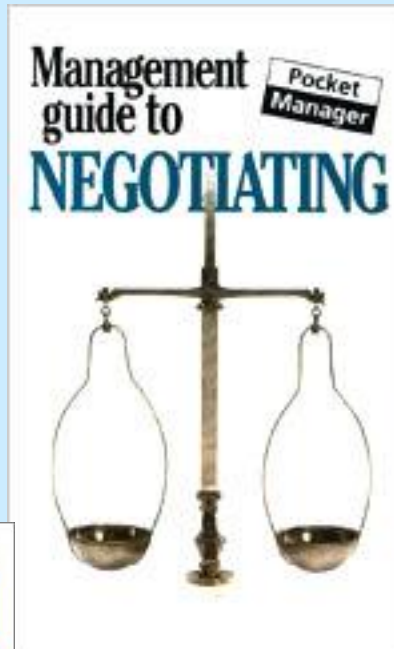
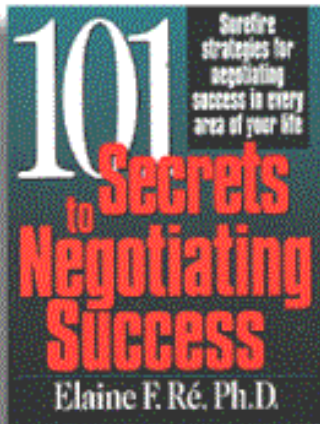
- **Lawsuit had been filed charging that Davis bond is a subterfuge to avoid constitutional requirements**
- **Legal objections would have had to be overcome before Davis bond could be sold**
- **If couldn't overcome legal problems, would have to move to Option #3**



temporary

- to Option #3, lenders
voter rejection of
bond and legal
is bond
get one of the 3
have run out of
debt service was
ice interruptions
occur.

Generic Negotiation Approach?



Generic Negotiation Approach?



Management
guide to
NEGOTIATING

Pocket
Manager

NEGOTIATING A
MUTUAL AGREEMENT



ARE THE LIMITS
BOUNDARIES ?



The National Best
Second Edition
Answers to Ten Questions

**GETTING
YES**

**Negotiating Agreement
Without Giving In**

Roger Fisher and William Ury
& for the Second Edition, Bruce Patton
of the Harvard Negotiation Project

A STEP-BY-STEP
GUIDE TO
PREPARING FOR ANY NEGOTIATION

Roger Fisher and Danny Ertel



*Is the budget problem
another version of a labor
negotiation?*



Who are the parties to the “negotiation”?

- **Legislature**
- **Governor**
- **Interest groups**
- **Electorate**



The problem isn't one of negotiating

Why can't
we all just
get along?

Rodney King



*We can't get along because of a
loss of trust between the
electorate and govt.*

**Why can't
we all just
get along?**

Rodney King

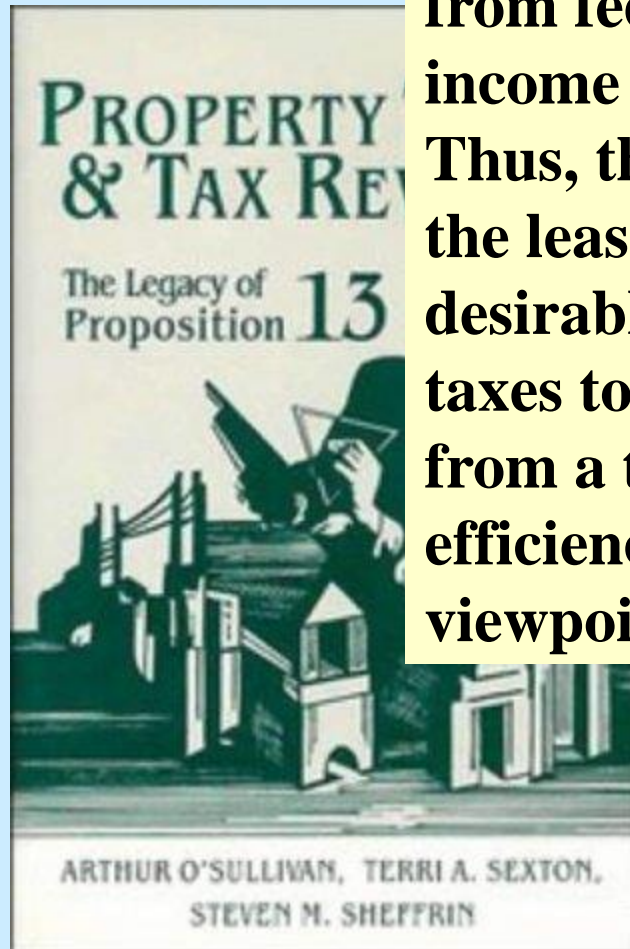


Howard Jarvis and Paul Gann celebrate



**Passage of Prop 13
(1978)**

Numerous Studies



Note that both property and car taxes are deductible from federal income tax. Thus, they are the least desirable taxes to cut from a tax efficiency viewpoint.

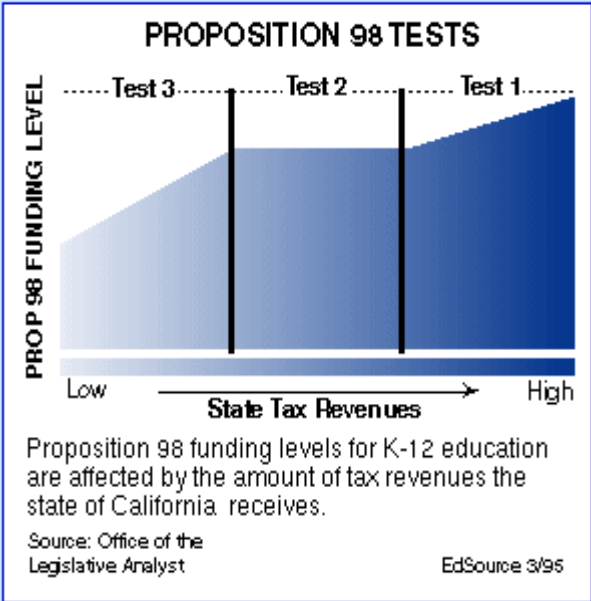
Question: Why was the *property tax* the focus of the taxpayer revolt?

Related Question: Why was the *car tax* such an issue in the recall?

Inadvertent consequence



**More dependence
on Sacramento ==>
more constraints
on Sacramento**



Inadvertent consequence



Fiscalization of land use



**BOTTOM LINE
QUESTION:**



***Why did we have a
taxpayer revolt?***



BOTTOM LINE QUESTION:



***Why do we still have a
taxpayer revolt?***

Looking Outside the General Fund



- Governor's proposed expenditures from GF for 2004-05 = \$80.3 billion (excluding funny math)
- Governor's proposed expenditure from special funds = \$21.1 billion
- Lesson: About one fifth of expenditures (excluding pensions) is outside the GF



Transportation

- **Special funds to receive \$7.8 billion in motor-vehicle related taxes**
 - Fuel taxes
 - Registration, weight, license, etc.
- **Total expenditure for business-transportation-housing is to be \$5.5 billion (not all for transportation)**



Prof. Jeffrey Brown



Florida State University
PhD Urban Planning 2003 ●

California State Archives



Sacramento



Gov. Olsen dedicates Arroyo Seco Parkway



...later known as the
Pasadena Freeway



Standard Federal Story

- **Constitution: Post roads**
- **Alternatives**
 - Rivers and canals
 - Railroads
- **Mainly local roads and local responsibility**
- **Good Roads movement**
- **Automobiles arrive**
- **Federal role expands with Bureau of Public Roads**



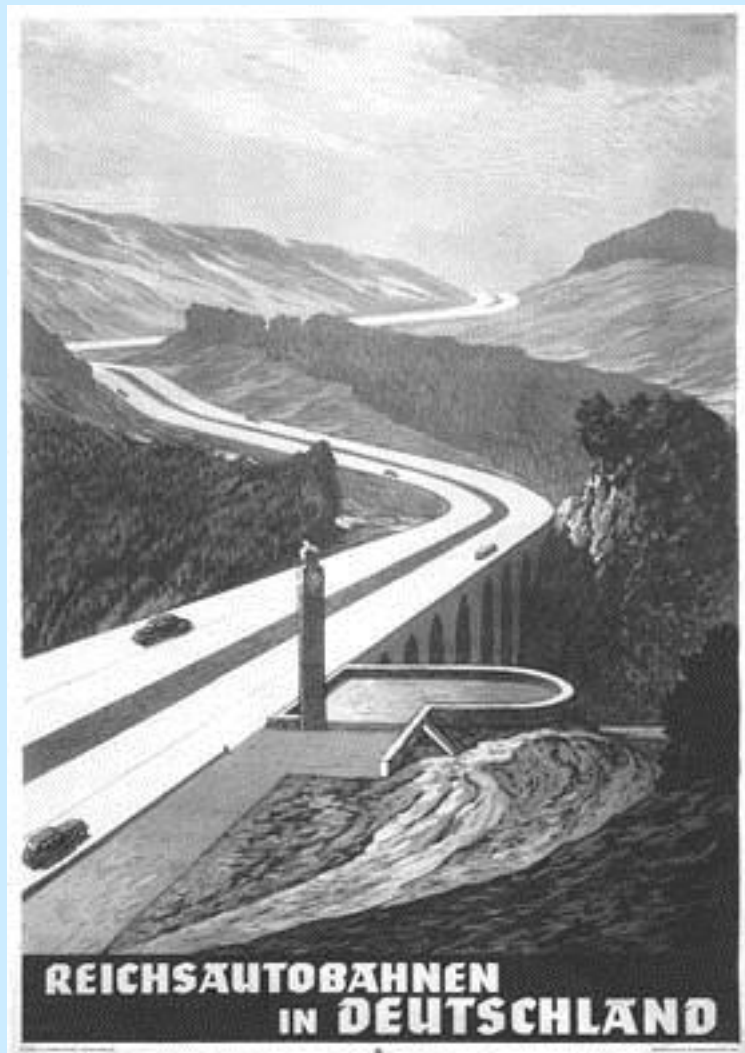
Standard Federal Story

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- **Automobiles arrive**
- **Federal role expands with Bureau of Public Roads**
- **Depression gas tax & public works**
- **“Toll Roads and Free Roads”
report of 1939 (with funny math)**

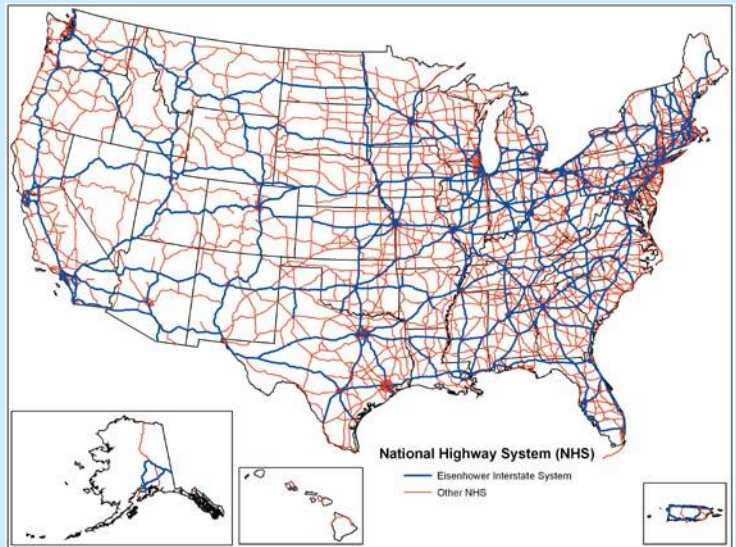


***“Germany ... made me see the wisdom
of broader ribbons across the land.”***

Dwight D. Eisenhower



1956: Federal Interstate and Defense Highway System Legislation



An interstate is born: The first was I-70 in Missouri and Kansas.



Federal-Aid Highway Act of 1956

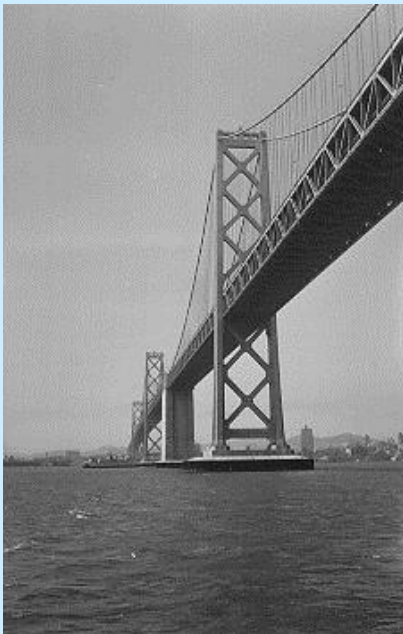
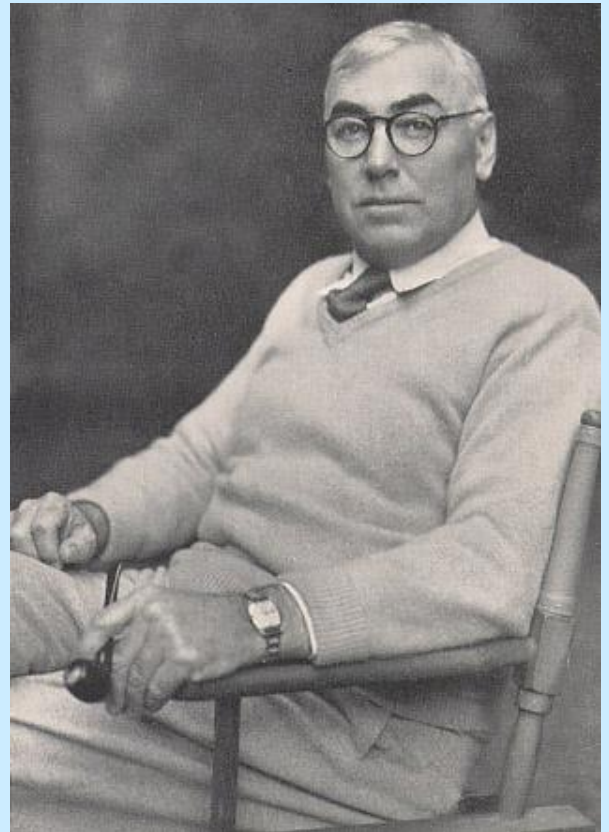
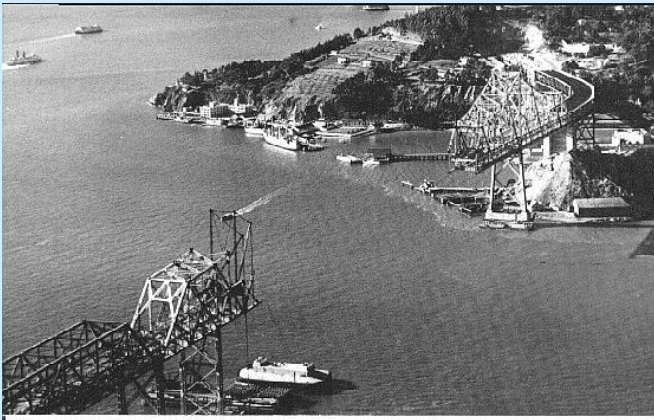
An Alternative California-centric Tale



Earl Warren



Charles H. Purcell



1940s Legislature

**“How are you today
Mr. Legislature?”**



Arthur H. Samish ●

Collier's, August 1949

Building of Lakewood, California



Annual rate of
growth:

Calif.: 4.4%

U.S.: 1.4%



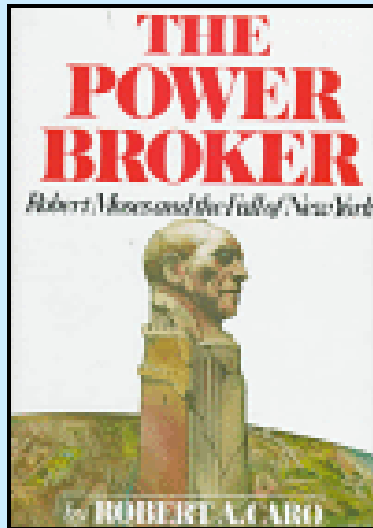
California Population in 1940:

7 million

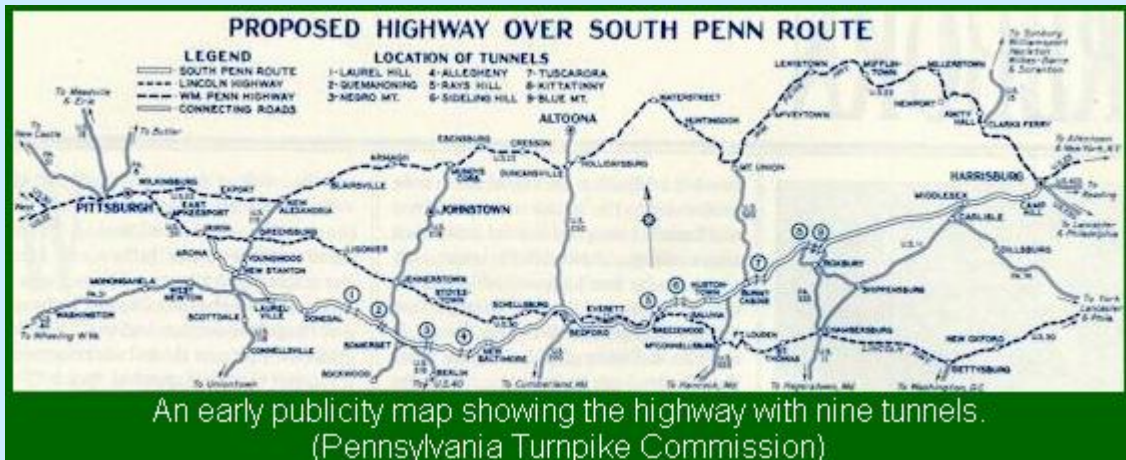
California Population in 1950:

10.6 million

Robert Moses and his NYC-area Parkways



Toll Roads?



Revenue Source: *Gas Tax*



Opposition from oil companies



Buses and Trucks



Let cars pay for it.



Collier-Burns Act (1947)

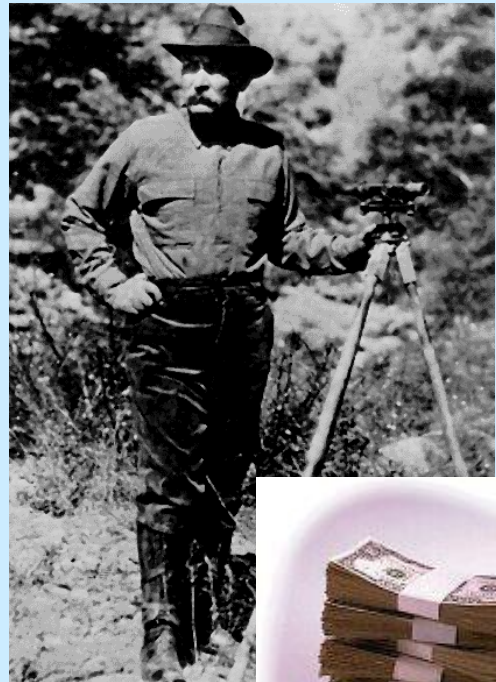
- **Proposal: Put gas and other motor-vehicle related taxes into trust fund to avoid “diversion”**
- **Raise gas and related taxes to build freeways and other roads**



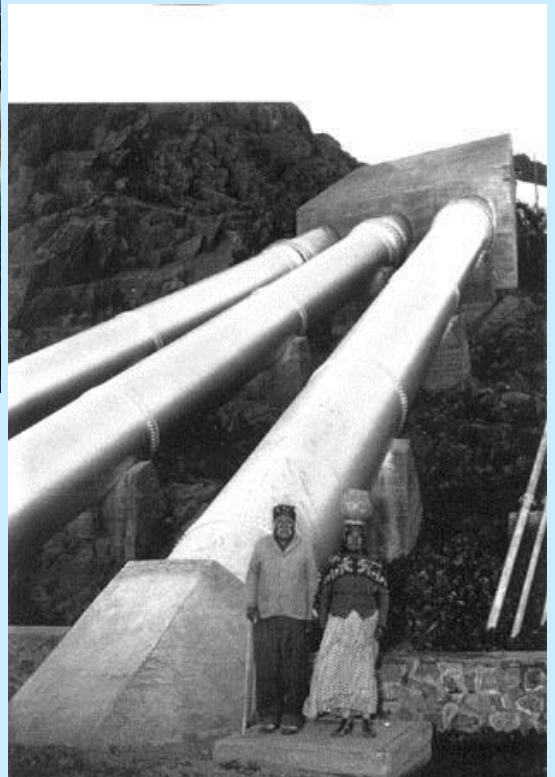
**Randolph Collier,
“Father of the American Freeways”
City of Yreka, CA
Dedicated 1995**



Owens Valley Project



Colorado Water Project



Master Plan for Higher Education





The California Deal

- **Vote bonds for water projects**
 - Get water paid for in water bills
- **Pay gas and related taxes**
 - Get roads and freeways
- **Pay state taxes**
 - Get higher education
- **Pay property tax**
 - Get schools, police, fire





The California Deal

- **Property taxes rise rapidly in 1970s due to rising real estate values**
 - Did schools, police, fire service improve proportionately?
 - Busing controversy in LA especially SF Valley weakens link between school and property tax payer
- **Car tax increase in 2003**
 - Were new roads, etc., going to result?



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Lesson #1

The conflict is with the electorate. Thus, negotiations models are not relevant. The state can't negotiate with the electorate.

●

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Lesson #2

Voters want the old California deal. Fiddling with term limits, etc., will not resolve the conflict.

●

California's Budget Conflict: *Lessons from the Present and the Past*



Lesson #3

**Need closer tie between taxes
paid and services delivered.
That implies user fees, move of
revenue and expenditure back
toward local govt.**

●

California's Budget Conflict: *Lessons from the Present and the Past*



Lesson #4

**Since deal was breached, need
devices to renew trust. Trust
funds, performance targets,
perceived accountability,
honest budgets.**



*And finally, now
that Props 57 & 58
were passed let's
have...*



Transparency in accounting:

- **Distinguish stocks from flows
(deficit and debt are different)**
- **Consistent methodology from
year to year**
- **Borrowing isn't revenue**
- **Revenues and expenditures
can't be negative**
- **Distinguish between managerial
accounting and bookkeeping**





FINANCIAL ACCOUNTING STANDARDS BOARD



Governmental Accounting Standards Board



THE CHRISTIAN SCIENCE MONITOR Bennett

Juggling the Numbers

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